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IN THE

Supreme Court of the United States

October Term, 1932

No. 448

PETROLEUM EXPLORATION, Inc., *Petitioner,*

against

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF OF AMERADA CORPORATION AS *AMICUS CURIAE*

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Preliminary Statement.

Amerada Corporation and its affiliates have claims for refund pending before the Commissioner of Internal Revenue involving the same question presented in the above entitled case. In all of the essential facts, except of course, the exact figures, the facts with respect to the Amerada claims are like the facts involved in this case, and a decision of this Court upon the questions of law involved will necessarily govern the action of the Commissioner of Internal Revenue upon such claims. It follows, therefore, that the Amerada Corporation is vitally interested in the decision

in the present case and proposes in this brief to show to this Court that the decision of the United States Circuit Court of Appeals for the Fourth Circuit was in error and that the decision of the Board of Tax Appeals, which was the Court of incidence in this case, was correct.

Opinion Below.

The opinion of the Board of Tax Appeals is reported in 23 B. T. A. 890. The opinion of the Circuit Court of Appeals is reported in 61 Fed. (2d), 273.

Jurisdiction, Statement of Fact and Statement of the Question Presented.

We adopt the statement of counsel for the petitioner as to the jurisdiction, the facts involved and the question presented to this Court. We will not burden the Court with an extended reiteration of them here.

Summary of Argument.

1. Sec. 234 (a) (8) of the Revenue Act of 1926 specifically provides for the recovery of capitalized drilling costs through an allowance for depreciation.

2. That Congress intended that improvements on mineral properties, including capitalized drilling costs, should be recovered through an allowance for depreciation is of public record.

3. The attempt of the respondent to require capitalized drilling costs to be recovered through an allowance for depletion is a perversion of the expressed mandate of the

Statute requiring that the Commissioner of Internal Revenue grant "a reasonable allowance for depletion".

4. Depletion and depreciation have come to have distinct and separate meanings in tax statutes and there is no basis for confusing the application thereof.

ARGUMENT.

I.

The statute prescribes return of capitalized drilling costs through depreciation.

Section 234 (a) (8) of the Revenue Act of 1926 (44 Stat. 42) provides as follows:

> "In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary."

It is established that if a word has a judicially settled meaning it must be presumed that it was used in that sense in the Statute in which it is found. (*U. S.* v. *Merriam*, 263 U. S. 179, 187; *Kepner* v. *U. S.*, 195 U. S. 100, 124; *The Abbotsford*, 98 U. S. 440, 444. In the "Glossary of Mining and Mineral Industry", published by the United States Bureau of Mines, the Bureau defines the word "improvement" in the following terms:

> "*Improvement.* As used in the mining statutes is an artificial change of the physical condition of the

> earth upon or reasonably near a mining claim as to evidence a design to discover mineral therein, or to facilitate its extraction. It must be reasonably permanent in character (*Frederick* v. *Klauser*, 32 Oregon 116."

Thus it appears that the term "improvement" has a well established definition in connection with the mining and mineral industry in language that is not ambiguous or susceptible of misinterpretation. It follows that when Congress used that word in the portion of the Statute above which deals with the mining industry, it must have used the word in its well accepted meaning and that therefore improvements, as so defined, are to be recovered through an allowance for depreciation.

II.

It is of public record that Congress intended that drilling costs incurred in improving oil fields are to be recovered through an allowance for depreciation.

The Revenue Act of 1918 [40 Stat. 1057], Sec. 214 (a) (10), pages 1066-1067, provided as follows:

> (a) "That in computing net income there shall be allowed as deductions:
>
> • • • • • • • •
>
> (10) "In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable al-

> lowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case * * *."

The phrase "and for depreciation of improvements" does not appear in the earlier Revenue Acts in connection with the depletion allowance and this addition to the Revenue Act of 1918 was explained by the report of the Ways and Means Committee of the House of Representatives, H. R. 767, 65th Congress, 2nd Session (p. 10) as follows:

> "The depletion provision of existing law does not grant an allowance for cost of development. In the case of mines, oil and gas wells, such an allowance seems only equitable and fair and the bill provides that a reasonable allowance in such cases be allowed for depreciation of improvements. * * *".

Thus it seems clear that Congress not only provided in this clause dealing with deductions in the case of natural resources that there should be a deduction allowed to the taxpayer on account of improvements, but its Committee specifically states that it was the intention that such allowance should be granted by way of depreciation. It follows that drilling costs which are part of the capital invested in the improvement were designedly included in the allowance for depreciation. This provision, in substantially identical language, has appeared in every Revenue Act since 1918, and it is specifically in the Revenue Act of 1926, as the quotation under Point I hereof shows.

III.

The Treasury Department regulation which requires that capitalized drilling costs must be returned through depletion allowance is arbitrary, discriminatory and in direct conflict with the mandate of the statute that there shall be a reasonable allowance for depreciation.

It is generally known that a large portion of the taxpayers comprising the oil industry charges drilling cost to expense as incurred and that another large portion charges drilling cost to capital account. Many cogent arguments can be adduced in support of either practice, but these are irrelevant as that question is not before this Court. So far as this petitioner is concerned, the facts show that it capitalized its drilling cost in accordance with a well recognized practice in the industry. The sole question involved is whether it must recover that cost through a depreciation allowance or through a depletion allowance.

Section 234 (a) (8) quoted above under Point I provides that there shall be a reasonable allowance for depletion and for depreciation of improvements. Since the Statute provides for a reasonable allowance for depletion and depreciation of improvements under regulations prescribed by the Department, it logically follows that the regulations so prescribed must likewise be reasonable. With full knowledge that both methods of dealing with drilling costs are used throughout the oil industry, the Treasury Department, in Regulations 69, Article 223, provides:

> "Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the ex-

> ploration of the property, drilling of wells, building of pipe line, and development of the property, may at the option of the taxpayer be deducted as a development expense or charged to capital account *returnable through depletion.*" (Italics supplied.)

The Department construes this Regulation to mean that if a taxpayer capitalizes his drilling costs he must recover them through his depletion allowance. The practical effect of this is to grant deductions to taxpayers, as follows:

> (A) To taxpayers who capitalize drilling cost: 27½ per centum of gross income, this deduction including the amount of the drilling cost.*

> (B) To taxpayers charging off drilling cost: 27½ per centum of gross income, *plus the amount of the drilling cost.** (See Sec. 204 (c) (2) Revenue Act of 1926).

The discrimination which the Regulation creates is at once apparent from the above statement. Obviously, therefore, the Regulation as applied to the capitalization of drilling costs is unjust, arbitrary and discriminatory, and cannot, under any stretch of the imagination, be considered as "reasonable" as prescribed and required by the Statute. It is, therefore, in direct conflict with the mandate of the Statute so far as it requires the recovery of these capitalized costs through depletion. Return of capitalized drilling costs through depreciation, as prescribed by the Statute, would place both groups of taxpayers on a basis of near parity.

For the sake of clarity there is appended hereto an illustration of the computation of depletion allowance on an

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* In both cases the depletion allowance might exceed 27½ per centum of gross income if such greater deduction is necessary to restore actual capital invested.

assumed set of figures and of taxable net income on three bases, as follows:

1. With drilling cost charged to expense.
2. With drilling cost capitalized and returned through depreciation.
3. With drilling cost capitalized and returned through depletion.

IV.

Depletion and depreciation have a well defined judicial meaning in tax statutes and there is no reason for confusing their scope.

As early as 1917 this Court was called upon to decide whether the exhaustion of a mineral deposit could be classified as depreciation (*Von Baumbach* v. *Sargent Land Co.*, 242 U. S. 503. The case arose under the Corporation Excise Tax Act of 1909. That Statute provided for the deduction from income of "all losses actually sustained within the year * * * including a reasonable allowance for depreciation of property." (See opinion, p. 524.) At the bottom of page 524 and at the top of page 525 there is found a very lucid discussion of this problem and the conclusion of the Court is very succinctly summarized in these words: "But in no accurate sense can such exhaustion of the body of the ore be deemed depreciation." (p. 525). This principle has been further clarified and elucidated by this Court in the case of *United States* v. *Ludey*, 274 U. S. 295. There can, therefore, no longer be any question as to the clear distinction in the meaning of these two words, or any cause for confusion in their application to a taxing statute.

V.

Comment on Brief Submitted by the Respondent.

The foregoing matter represents, we submit, a conclusive case, but the brief filed by the respondent contains many cleverly worded statements which should not go unanswered.

Since the Government in its brief in this case simply refers to and relies upon the arguments set forth in its brief in the companion case, *United States* v. *Dakota-Montana Oil Company*, No. 434, October term, 1932, the references below are necessarily to the brief of the Government in the last named case.

A. The respondent argues that since drilling cost is not represented by tangible physical property, it is not properly subject to the depreciation allowance. This argument fails because the hole drilled in the ground is an integral part of a physical object, namely, a completed oil well. Furthermore, excavations for building foundations, bridge emplacements and tunnels, are not tangible physical properties taken alone, but manifestly, the complete foundations, the emplacements and the tunnels are physical properties and as such are proper subjects for depreciation allowance. The Department has never attempted to segregate the costs of excavations of these types from the cost of the completed structure in arriving at an allowance for depreciation. A simple example may illustrate the point here made. If a manufacturing organization excavated for an aqueduct to carry water from an available water supply to its plant and abandoned such excavation when partially or wholly completed, no one would argue that the excavation was subject

to depreciation, much less depletion. But if, after completing the excavation the organization placed therein a proper metal or other conduit for the purpose of carrying the water to the plant, no one would gainsay the right of such organization to depreciate the entire cost of the aqueduct, including the cost of the excavation, over its useful life. It is difficult to see any basis of distinction between such a case and the case of an oil well.

B. The respondent argues that because the drill hole has no useful life subsequent to the exhaustion of the mineral reserve, the drilling cannot be recovered through depreciation. This argument fails as the Statutes for many years have authorized an allowance for depreciation in the following terms:

> "* * * a reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence." (Sec. 214 (a) (8), Revenue Act of 1926 and corresponding sections of earlier Revenue Acts.)

Attention is directed to the fact that the allowance for depreciation specifically comprehends exhaustion.

C. The respondent argues that the regulations have received implied legislative approval. This is not the case, as the regulations, far from having received implied legislative approval, are in distinct conflict with the Statute and with the recorded intent of Congress as shown in Points I, II and III above.

D. The respondent argues that election to charge drilling costs to capital account as authorized by the regulations necessarily involved acceptance of the proviso in the regu-

lation that such drilling cost must be recovered through depletion. That taxpayers did not recognize the Department's attempt to arrogate to itself the right to alter and amend the Statue is clearly shown by the fact that there are three cases involving this question now pending before this Court, and by the fact that many additional cases involving this point are pending before the Bureau and will be settled in conformity with the decision of this Court.

E. The respondent argues that depreciation of drilling cost cannot be computed under the usual method of determining depreciation. This is not so. The practice of computing depreciation of casings, derricks and other physical property by means of the "unit of production method" is widely followed throughout the oil industry. The use of this method is not only accepted, but encouraged by the Bureau of Internal Revenue. See Treasury Department, Bureau of Internal Revenue, Bulletin "F" on Depreciation and Obsolescence (1920) page 30, where it states:

> "The capital sum to be replaced by allowance for depreciation should be charged off over the useful life of the property, either in equal instalments, this plan being generally known as the 'fixed percentage' method, or in accordance with any other recognized trade practice, such as apportionment over units of production."

Depreciation under this method is concurrent with and in direct proportion with recovery of the oil, and the depreciable investment in physical property is extinguished simultaneously with exhaustion of the deposit. Obviously no impropriety or inaccuracy would result from computing depreciation of drilling cost under the unit of production method.

VI.

Appendix B of Respondent's Brief.

Some reference should likewise be made to statements contained in Appendix B of the respondent's brief in *United States* v. *Dakota-Montana Oil Co.*, No. 434.

A. On pages 32 and 33, in attempting to draw a distinction between tangible and intangible costs, it is implied that physical equipment such as casing, derricks, etc., is properly subject to depreciation because it can be salvaged and transferred for use elsewhere, and that because the drill hole cannot be transferred for use elsewhre it is not subject to depreciation. This completely ignores the fact that the drill hole is an integral part of the oil well itself and is entirely inconsistent with the practice of the Bureau with respect to building foundations, dams, bridge emplacements, tunnels, aqueducts and similar facilities.

B. On pages 34 and 35 much is made of the fact that when the Revenue Act of 1918 was passed, section 234 (a) (9) provided for a reasonable allowance for depletion of oil and gas wells, the word "wells" being italicized throughout. There might have been some force to this argument had not these words been lifted bodily out of the context in which they appeared. Section 234 (a) (9) of the Revenue Act of 1918 provides: "In the case of mines, oil and gas wells, other natural deposits, and timber," there shall be a reasonable allowance for depletion and depreciation of improvements. The association of the words in the context shows clearly that Congress was referring to the natural deposits of oil and gas, not to the artificial wells built by man. Furthermore, when similar legislation was under

consideration when the Revenue Bill of 1926 was being proposed in Congress, the Senate Committee on Finance, Senate Report No. 52, 69th Congress, first session, pages 17 and 18, referring to the new provision relating to oil and gas wells, states:

> "The new sub-division provides that in the case of oil and gas wells discovered by the taxpayer on or after January 1, 1925, in an area not proven at the date of such discovery * * *."

The physical structure that comprises an oil or gas well which was here being considered is certainly not "discovered" by the taxpayer. It is quite obvious that Congress, in using the words "oil and gas wells" in Section 204, subdivision (c) of the Revenue Act of 1926, referred to the natural oil or gas deposit, as this history of the legislation plainly shows. Thus the much italicized use in this appendix of the word "wells" has very little force, when viewed in the light of the context of the Statute and the legislative history concerning it.

Conclusion.

The decision of the Board of Tax Appeals should be affirmed.

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Dated, New York, January , 1933.

Appendix.

ILLUSTRATION OF COMPUTATION OF TAXABLE INCOME

showing effect of decision in this case.

For this purpose it is assumed that, over the entire operating life of a property, the following results were obtained:

Lease cost	$ 100,000.00
Oil Sales	1,000,000.00
Production Expense, etc.	100,000.00
Well Cost:	
Equipment (Assumed no salvage value)	150,000.00
Intangible Drilling Cost	150,000.00

Taxable Income Under 1926 Act

	Drilling Cost Charged off	Drilling Cost Capitalized Restored through Depreciation	Drilling Cost Capitalized Restored through Depletion
Gross Income	$1,000,000.00	$1,000,000.00	$1,000,000.00
Deduct:			
Production Expense, etc.	$ 100,000.00	$ 100,000.00	$ 100,000.00
Drilling Cost Charged off	150,000.00	None–Capitalized	None–Capitalized
Depreciation:			
Of Equipment	150,000.00	150,000.00	150,000.00
Of Drilling Cost	None–Charged off	150,000.00	None–included with depletion
Total Deductions	$ 400,000.00	$ 400,000.00	$ 250,000.00
Net Income—before depletion	$ 600,000.00	$ 600,000.00	$ 750,000.00
27½% of Gross Income (See Sec. 204(c)(2) Revenue Act of 1926)	$ 275,000.00	$ 275,000.00	$ 275,000.00
50% of Net Income before depletion (See Sec. 204(c)(2) Revenue Act of 1926)	$ 300,000.00	$ 300,000.00	$ 375,000.00
Statutory Depletion allowance (See Sec. 204(c)(2) Revenue Act of 1926)	$ 275,000.00	$ 275,000.00	$ 275,000.00
The Statutory Depletion Allowance Comprises:			
Return of Lease Cost	$ 100,000.00	$ 100,000.00	$ 100,000.00
Return of Capitalized Drilling Cost	None–Charged off	None–Returned through depreciation	150,000.00
Allowance in excess of amount needed to return capital invested	$ 175,000.00	$ 175,000.00	$ 25,000.00
Total	$ 275,000.00	$ 275,000.00	$ 275,000.00
Net Income before Depletion—shown above	$ 600,000.00	$ 600,000.00	$ 750,000.00
Statutory Depletion Allowance	275,000.00	275,000.00	275,000.00
Taxable Net Income	$ 325,000.00	$ 325,000.00	$ 475,000.00